

"In the short-term the market is a voting machine, in the long-term, a weighing one."

- Benjamin Graham

Investment Perspectives

Economies Still Recovering?

Disappointing economic headlines in May fanned investor fears about decelerating economic growth. Temporary supply disruptions resulting from the Japan earthquake and tsunami plus the spike in energy prices were noted as main reasons for the slowdown. These unforeseen setbacks added to the ongoing headwinds of the financial crisis. Piling on to Europe's credit troubles, the U.S. debt ceiling showdown unfolded in prime time. Investors again questioned the potential to destroy demand and corporate profits, as reflected in slipping stock prices.

To check our bearings we look to the business cycle. This mid-cycle slowdown in growth is typical of similar points in prior recoveries; as the major rebuilding of inventories post-recession ends. The average duration of business cycles in the post WWII period is about five years from trough to trough. We are roughly two years into the recovery that began mid-2009.

While conceding that growth is weaker than forecast,

the expansion is expected to advance at a moderate pace. Recent developments reduced the consensus global growth to below 4.0% in 2011. China's growth moderated but is still in an 8.5% expansion zone for 2011. This year Canada and U.S. GDP growth will range from 2.5% to 2.7%. Below-average growth in the recovery period is consistent with debt levels in the advanced economies. Household and government debt subtract from economic growth as spending restraints.

The fundamental underpinnings to the economy remain intact, i.e. exceptionally low borrowing costs. A return to stronger growth is still expected as businesses increase capital spending, export growth proceeds and private-sector demand for labour expands. However, the weak U.S. housing market and concerns about sovereign debt remain drags on the outlook. Generally equity markets perform well following a resumption of growth. *As always, we thank you for your continued confidence and support.*

Equities:

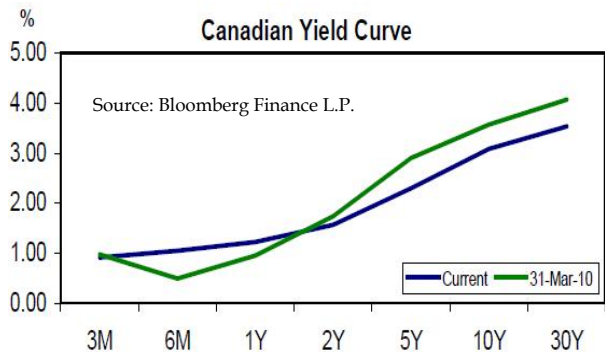
Reminiscent of 2010's pattern, markets performed well until April. In May, amid concerns about a slowdown in the global economic recovery, equities declined. The synchronized correction removed about 10% from the Canadian market's peak versus 7% from the U.S. large-stock index. Canada's underperformance highlights the energy sectors' influence, comprising 27% of the S&P/TSX Composite index.

Hampering the U.S. recovery were high oil prices, persistently high unemployment, and a fragile housing market. China's inflation fighting campaign, i.e. monetary tightening, raised fear that it might stall economic growth. As the majority of world growth originates in emerging markets, a severe slowdown would jeopardize the global recovery. Last, as an important compo-

nent supplier, the dislocations after Japan's twin natural disasters impacted all of its trading partners' manufacturing sectors.

The left-hand charts show the twelve-month price performance for Canadian, U.S., and international stocks. Year-to-date Canadian stocks underperformed their U.S. counterparts. For the first six months of 2011, the S&P/TSX Composite is down by -1.1% (0.16% total return with dividends). Cyclically sensitive sectors lagged the most so far in 2011: Technology (-31%), Golds (-13%), and Materials (-10%). Translated into Canadian dollars the S&P 500 gained 1.4% (versus 5.0% measured in U.S. dollars). Both the MSCI EAFE and MSCI Emerging Markets indices ended in negative territory at -2.1% and -5.0%, respectively.





Fixed Income and Interest Rates:

Rate hikes in Canada and the U.S. are still on hold. Persistent slack within the North American economies—notably in employment—has limited core price inflation, which excludes food and energy prices. The already fragile U.S. recovery likewise has delayed any urgency to raise the key policy rates in North America. A gradual withdrawal of monetary stimulus, i.e. the raising of interest rates, is now anticipated to begin late 2011 in Canada and possibly not until late 2012 in the U.S.

By the end of the second quarter, fixed income investment flows began funnelling back to America, again seeking safe haven, with political unrest brewing in the Middle

East and the continued European debt crisis. In addition, persistent U.S. worries—slow down in growth and gridlock in Washington—drove demand back into U.S. Treasuries, driving prices higher and yields lower. The yield on the 10-year note slipped below 3.00% in June, closing at 3.18%. Low yields in the bond market signal a lack of confidence in riskier assets, such as equities. Even so, these low yields offer investors no protection against higher inflation.

As illustrated to the left, the Canadian yield curve plots interest rates on short through to long-term bonds. A very steep upward sloping yield curve usually supports equities – favouring lending and spending.

Currencies:

The loonie continued to appreciate, gaining 3.1% against the U.S. dollar. The Canadian dollar has averaged 103 cents US over the last six months, which is higher than the Bank of Canada expected in January. The meteoric rise in oil prices in large part contributed to our dollar's peak at 105.80 in May. The Canadian dollar is expected to remain stronger than the U.S. dollar, on average, as the global expansion cycle continues.

Meanwhile, two credit rating agencies have warned that they will strip the U.S. of its prized AAA rating if policy-makers do not backstop the government's creditworthiness by raising the debt ceiling to prevent a default. A rating downgrade would have a devastating effect on the U.S. dollar. That AAA rating is one of the reasons why the U.S. dollar is viewed as a 'safe haven' currency. It is America's debt quality that has kept its interest rates low and its economy supported by foreign investors.

Commodities:

The price of oil hit a two-year high in April reaching US \$114/bbl. The surprise factor boosting oil was hostilities in the Middle East and North Africa. Speculative trading in oil futures is also partly to blame. In response, the International Energy Agency released a 60-million-barrel infusion of oil, followed by 30 million barrels from the U.S. strategic reserves. Since then oil prices have fallen by about 20%. Relief from soaring gas prices at the pump was to help cushion U.S. consumer spending. Closing at US \$95/bbl at the end of June, prices remain elevated compared to last year's average US \$79/bbl. Continuing demand from the developing BRIC countries has more than

offset any consumption reductions in the U.S. and Europe.

The run-up in gold metal prices continued. After hitting an all-time high of around US \$1,564 in April, it closed at US \$1,500.40 per ounce. Viewed as a haven against collapsing global currencies, demand for gold is fuelled by continued financial market instability. Increases reflect gold investors' bet against the ability of world economies to solve their problems. However, the recent bullion-gold stock disconnect, i.e. share prices of gold producers not responding to the metal's price, reflects reservation by long-term investors on that bet.

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